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About the Company

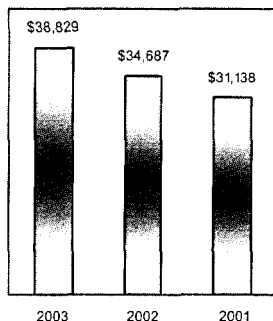
Back Yard Burgers operates and franchises quick-service restaurants that specialize in charbroiled, freshly prepared, great tasting food. As our name implies, Back Yard Burgers strives to offer the same high-quality ingredients and special care typified by outdoor grilling in the back yard. Our menu features made-to-order gourmet 100% Black Angus hamburgers and chicken sandwiches charbroiled over an open flame, fresh salads, chili and other special entrees, as well as hand-dipped milkshakes, fresh-made lemonade and fresh-baked cobblers.

Our goal for 2004 is to continue to position Back Yard Burgers as a favored regional premium fast food restaurant chain. We intend to add more restaurants to our family and further enhance our existing dine-in facilities. We will strive to live our vision – “As a team, provide the ultimate restaurant experience to our guests.” We plan to continue to creatively communicate our points of differentiation - charbroiled 1/3 pound 100% Black Angus beef hamburgers, charbroiled chicken sandwiches and our unique “Back Yard” favorites.

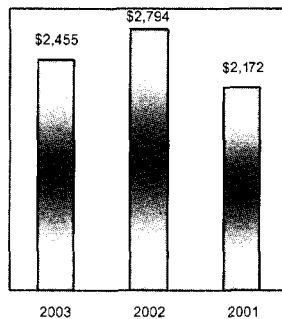
Financial Highlights

(in thousands, except per share amounts and units)

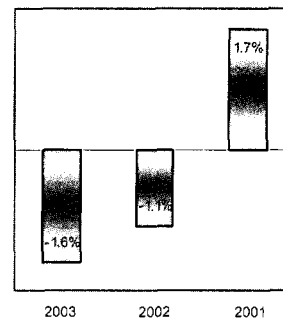
	January 3, 2004	December 28, 2002	December 29, 2001
<i>For the year ended:</i>			
Restaurant sales	\$ 34,279	\$ 30,951	\$ 27,541
Total revenues	38,829	34,687	31,138
Net income	1,309	1,477	1,027
Net income per share:			
Basic	0.28	0.31	0.22
Diluted	0.26	0.29	0.22
Weighted average shares outstanding:			
Basic	4,732	4,709	4,635
Diluted	5,053	5,058	4,757
 System-wide sales	 \$ 100,524	 \$ 84,951	 \$ 77,706
Units in operation:			
Company-owned	42	42	37
Franchised	90	77	67
Total	<u>132</u>	<u>119</u>	<u>104</u>



Total Revenues
(**\$000's**)



Operating Income
(**\$000's**)



**System-wide
Same-Store
Sales %***

* Depicts percentage increase or decrease over previous year's system-wide same-store sales.

Note: Because the company's fiscal year ends on the Saturday closest to December 31, the fiscal year ended January 3, 2004 contains 53 weeks, while the fiscal years ended December 28, 2002 and December 29, 2001 contain 52 weeks.

To Our Shareholders

Welcome back to our Back Yard! Fiscal year 2003 was another record year for sales for Back Yard Burgers, Inc. I continue to be extremely proud of our team and its accomplishments. We further solidified our position as a leading regional "premium" fast food provider. Our team is committed to building sales and profits for our shareholders.

We continue to strive to be the leader of "premium" fast food and to exploit what makes Back Yard Burgers better than the rest. Living by our Mission Statement – "OUR TEAM GUARANTEES THE HIGHEST DEGREE OF SERVICE AND THE BEST TASTING FOOD IN A PLEASANT ATMOSPHERE, EVERY DAY TO EVERY GUEST." Our team is working daily to make our product and our people a point of differentiation. We are serious about the taste of our food.

We achieved a significant milestone in 2003 by exceeding \$100 million in systemwide sales, solidifying our position as a major regional restaurant concept. In the past twelve months, we have also signed franchise and area development agreements for 152 stores, which should continue to expand our presence within the Southeastern United States.

Our on-going strategies for success are as follows:

FRANCHISING – We will continue to actively promote expansion by awarding more franchise territories. We believe our strongest growth vehicle is adding franchise locations. We are very proud of our "Family" of franchise owners.

RESTAURANT OPERATIONS – Our new prototype facility introduced in 2001 positions Back Yard Burgers as "the upscale" quick service restaurant in our category. It provides an attractive exterior and interior appearance, as well as the operational efficiencies needed to increase throughput.

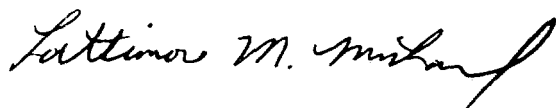
PRODUCTS – We continue to focus on making our great tasting products even better. We are the leader in taste and quality in the quick-service restaurant industry. We will not sacrifice quality for price.

MARKETING – Our award winning marketing programs will continue to creatively promote our points of differentiation, emphasizing what makes us better than the rest.

The beginning of 2003 was challenging for our industry, but the year ended on a positive note. Sales trends versus the prior year improved during the latter half of 2003 and fourth quarter 2003 profitability was up 10% over the prior year. Consumer spending improved and the economy showed signs of a positive recovery.

Our achievements in 2003 were significant, but I also realize we must continue to implement the proven strategy that has enabled us to enhance the value of our company up to this point. We are creating an environment that will perpetuate the growth of our people and our company. Our team is committed, experienced, and passionately working to build a successful restaurant company. The demographic trends are favorable given the desire for more flavorful dining options. Our points of differentiation deliver a positive opportunity for our company, our guests, and our shareholders. ENJOY!

Sincerely,



Lattimore M. Michael
Founder, Chairman and CEO

Forward-Looking Information

This document and other written reports and oral statements made from time to time by Back Yard Burgers and its representatives contain forward-looking statements. These statements, which are not statements of historical fact, may contain estimates, assumptions, projections and/or expectations regarding our financial position, results of operations, growth strategy and plans for future expansion, product development, economic conditions, and other similar forecasts and statements of expectation. We generally indicate these statements by words or phrases such as “anticipate,” “estimate,” “plan,” “expect,” “believe,” “intend,” “foresee,” and similar words or phrases. Forward-looking statements are based upon estimates, projections, beliefs and assumptions of management at the time of such statements and should not be viewed as guarantees of future performance. Such forward-looking information involves important risks and uncertainties that could significantly impact anticipated results in the future and, accordingly, such results may differ materially from those expressed in any forward-looking statements by or on behalf of the company. The factors that could cause our actual results to differ materially, many of which are beyond our control, include, but are not limited to, the following: delays in opening new stores or outlets because of weather, local permitting, and the availability and cost of land and construction; increases in competition and competitive discounting; increases in minimum wage and other operating costs; shortages in raw food products; volatility of commodity prices; consumer preferences, spending patterns and demographic trends; the possibility of unforeseen events affecting the industry generally, and other risks described from time to time in our periodic reports filed with the Securities and Exchange Commission. Back Yard Burgers, Inc. disclaims any obligation to update or revise any forward-looking statement based on the occurrence of future events, the receipt of new information, or otherwise.

Selected Consolidated Financial Data

(in thousands, except per share data)

The selected consolidated financial data presented below for each of the years in the five-year period ended January 3, 2004 was derived from the company’s audited Consolidated Financial Statements. The selected consolidated financial data should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto included elsewhere herein.

	January 3, 2004 ⁽³⁾	December 28, 2002	December 29, 2001	December 30, 2000	January 1, 2000
OPERATIONS					
Restaurant Sales	\$ 34,279	\$ 30,951	\$ 27,541	\$ 26,182	\$ 26,480
Total revenues	38,829	34,687	31,138	29,260	29,295
Income (loss) before income taxes	1,899 ⁽¹⁾	2,203	1,579	728	(930) ⁽²⁾
Net income (loss)	1,309	1,477	1,027	466	(558)
FINANCIAL POSITION					
Total assets	\$ 24,500	\$ 22,067	\$ 19,508	\$ 17,779	\$ 18,340
Property and equipment, net	18,717	17,247	14,176	12,569	13,211
Debt	5,350	5,925	5,772	5,403	6,178
Shareholders’ equity	13,687	12,284	10,591	9,555	9,058
PER SHARE DATA					
Net income (loss) – basic	\$ 0.28	\$ 0.31	\$ 0.22	\$ 0.10	\$ (0.12)
Net income (loss) – diluted	\$ 0.26	\$ 0.29	\$ 0.22	\$ 0.10	\$ (0.12)
Dividends	0.00	0.00	0.00	0.00	0.00
Market price at year end	6.52	4.00	3.70	0.66	1.50
OTHER DATA					
System-wide sales	\$100,524	\$ 84,951	\$ 77,706	\$ 68,439	\$ 65,119
Capital expenditures	3,329	4,861	2,791	1,063	2,679

⁽¹⁾ The company incurred a non-cash charge for impairment of long-lived assets of \$78,000 during the year ended January 3, 2004.

⁽²⁾ The company incurred a non-cash charge for impairment of long-lived assets of \$1,362,000 during the year ended January 1, 2000.

⁽³⁾ Because the company’s fiscal year ends on the Saturday closest to December 31, the fiscal year ended January 3, 2004 contains 53 weeks, while the fiscal years ended December 28, 2002, December 29, 2001, December 30, 2000 and January 1, 2000 contain 52 weeks.

The selected consolidated financial data presented below is a summary of the unaudited quarterly results of operations for the year ended January 3, 2004:

	Year Ended January 3, 2004			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Revenues:				
Restaurant sales	\$7,577	\$8,870	\$8,739	\$9,093
Franchise and area development fees	90	75	20	193
Royalty fees	582	668	664	707
Advertising fees	145	167	162	187
Other	180	408	230	72
Total Revenues	8,574	10,188	9,815	10,252
Expenses:				
Cost of restaurant sales	2,418	2,939	2,912	2,848
Restaurant operating expenses	3,641	4,190	4,300	4,326
General and administrative	1,095	1,188	1,096	1,154
Advertising	477	599	604	669
Depreciation and amortization	420	465	448	507
Impairment of long-lived assets	--	--	--	78
Total expenses	8,051	9,381	9,360	9,582
Operating income	523	807	455	670
Interest income	3	1	1	1
Interest expense	(126)	(126)	(124)	(119)
Other, net	(15)	(13)	(21)	(18)
Income before income taxes	385	669	311	534
Income tax expense	135	234	109	112
Net Income	\$ 250	\$ 435	\$ 202	\$ 422
Income per share:				
Basic	\$ 0.05	\$ 0.09	\$ 0.04	\$ 0.09
Diluted	\$ 0.05	\$ 0.09	\$ 0.04	\$ 0.08
Weighted average number of common shares and common equivalent shares outstanding:				
Basic	4,721	4,728	4,736	4,740
Diluted	4,979	5,061	5,056	5,113

The selected consolidated financial data presented below is a summary of the unaudited quarterly results of operations for the year ended December 28, 2002:

	Year Ended December 28, 2002			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Revenues:				
Restaurant sales	\$7,311	\$8,279	\$7,823	\$7,538
Franchise and area development fees	27	17	81	102
Royalty fees	516	566	541	549
Advertising fees	130	135	142	141
Other	195	199	189	206
Total Revenues	8,179	9,196	8,776	8,536
Expenses:				
Cost of restaurant sales	2,291	2,588	2,390	2,289
Restaurant operating expenses	3,470	3,746	3,730	3,590
General and administrative	1,066	1,040	1,047	1,280
Advertising	460	525	499	501
Depreciation and amortization	325	345	363	348
Total expenses	7,612	8,244	8,029	8,008
Operating income	567	952	747	528
Interest income	4	4	4	5
Interest expense	(132)	(117)	(133)	(138)
Other, net	(79)	14	(15)	(8)
Income before income taxes	360	853	603	387
Income tax expense	133	316	217	60
Net Income	\$ 227	\$ 537	\$ 386	\$ 327
Income per share:				
Basic	\$ 0.05	\$ 0.11	\$ 0.08	\$ 0.07
Diluted	\$ 0.04	\$ 0.11	\$ 0.08	\$ 0.07
Weighted average number of common shares and common equivalent shares outstanding:				
Basic	4,691	4,713	4,717	4,718
Diluted	5,111	5,097	5,088	4,990

Management's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

The following discussion and analysis should be read in conjunction with the company's consolidated financial statements and notes thereto, included elsewhere in this annual report. Because Back Yard Burgers' fiscal year ends on the Saturday closest to December 31, fiscal 2003 contains 53 weeks versus 52 weeks for 2002 and 2001. As a result, operating results for fiscal 2003 are not directly comparable with those of the prior 52-week periods.

As of January 3, 2004, the Back Yard Burgers system included 132 restaurants, of which 42 were company-operated and 90 were franchised. The company's revenues are derived primarily from company-operated restaurant sales, franchise and area development fees and royalty fees. Certain expenses (cost of restaurant sales, restaurant operating expenses, depreciation, amortization and advertising) relate directly to company-operated restaurants, while general and administrative expenses relate to both company-operated restaurants and franchise operations. The company's revenues and expenses are affected by the number and timing of the opening of additional restaurants. Sales for new restaurants in the period immediately following their opening tend to be high because of trial by public and promotional activities. As a result, the timing of openings can affect the average volume and other period-to-period comparisons.

Results of Operations

The following table sets forth the percentage relationship to total revenues, unless otherwise indicated, of certain items included in the company's historical operations and operating data for the periods indicated.

	For the Years Ended		
	January 3, 2004	December 28, 2002	December 29, 2001
Revenues			
Restaurant sales	88.3%	89.2%	88.5%
Franchise and area development fees	1.0	0.6	1.0
Royalty fees	6.7	6.3	6.4
Advertising fees	1.7	1.6	1.6
Other operating revenue	<u>2.3</u>	<u>2.3</u>	<u>2.5</u>
Total revenue	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Costs and Expenses			
Cost of restaurant sales ⁽¹⁾	32.4%	30.9%	31.9%
Restaurant operating expenses ⁽¹⁾	48.0	47.0	47.3
General and administrative	11.7	12.8	12.6
Advertising	6.0	5.7	5.9
Depreciation and amortization	4.7	4.0	4.4
Impairment of long-lived assets	0.2	--	--
Operating income	6.3	8.1	7.0
Interest income	0.0	0.1	0.1
Interest expense	(1.3)	(1.5)	(1.8)
Other, net	(0.2)	(0.3)	(0.2)
Income before taxes	4.9	6.4	5.1
Income tax expense ⁽²⁾	31.1	33.0	35.0
Net Income	3.4	4.3	3.3

⁽¹⁾ As a percentage of restaurant sales.

⁽²⁾ As a percentage of income before taxes.

	For the Years Ended		
	January 3, 2004	December 28, 2002	December 29, 2001
Operating data (in thousands)			
Restaurant sales			
Company-operated	\$ 34,279	\$ 30,951	\$ 27,541
Franchised	<u>66,245</u>	<u>54,000</u>	<u>50,165</u>
Total	<u>\$ 100,524</u>	<u>\$ 84,951</u>	<u>\$ 77,706</u>
Average annual sales per restaurant open for a full year ⁽¹⁾			
Company-operated	\$ 826,000	\$ 778,000	\$ 777,000
Franchised	782,000	810,000	790,000
System-wide	799,000	797,000	784,000
Number of restaurants ⁽²⁾			
Company-operated	42	42	37
Franchised	<u>90</u>	<u>77</u>	<u>67</u>
Total	<u>132</u>	<u>119</u>	<u>104</u>

(1) Includes sales for restaurants open for entire trailing twelve-month period. Restaurants are included in the calculation after the completion of six months of operations, as sales during the period immediately after opening tend to be higher due to promotions and trial by public.

(2) As of March 16, 2004, four franchised restaurants have opened and two franchised restaurants have closed since January 3, 2004.

COMPARISON OF FISCAL YEAR 2003 TO FISCAL YEAR 2002

Back Yard Burgers' fiscal year ends on the Saturday closest to December 31. As a result, fiscal 2003 contains 53 weeks versus 52 weeks for the prior year. Therefore, all references to fiscal 2003 are for the 53-week period ended January 3, 2004 and all references to fiscal 2002 are for the 52-week period ended December 28, 2002.

Restaurant sales at company-operated restaurants increased 10.8% to \$34,279,000 during 2003 from \$30,951,000 during 2002. In addition to the fact that fiscal year 2003 contained 53 weeks compared with 52 weeks in fiscal year 2002, the increase is partially the result of a 2.6% increase in same-store sales at restaurants open for more than one year. While the company ended 2002 with 42 restaurants, two of those restaurants opened in late 2002, which also contributed to the increase in restaurant sales.

Franchise and area development fees were \$378,000 during 2003, an increase of 66.5% from \$227,000 in 2002. Nineteen new franchised restaurants were opened in 2003, compared to fifteen new franchised units opened in 2002. A portion of the increase in fees is also attributable to the company recording \$86,000 in fees for the cancellation of franchise and area development agreements in 2003 compared with \$18,000 in 2002.

Royalty fees increased 20.7% to \$2,621,000 during 2003 from \$2,172,000 during 2002. The increase is the result of an increase in franchised sales upon which the fees are based. In addition to the fact that fiscal year 2003 contained 53 weeks compared with 52 weeks in fiscal year 2002, the increase in franchised restaurant sales was due to a net unit growth of thirteen franchised stores. The increase is partially offset by a decrease of 4.2% in same-store sales for franchised units during 2003.

Advertising fees increased 20.6% to \$661,000 for 2003 from \$548,000 during 2002. The increase is primarily due to the increase in franchised restaurant sales, upon which the fees are based.

Other revenues increased 12.8% to \$890,000 for 2003 from \$789,000 during 2002. The increase in other revenues is due to higher volume rebates from vendors, sales of proprietary spices and other miscellaneous revenues.

Cost of restaurant sales, consisting of food, beverage and paper costs, totaled \$11,117,000 during 2003 compared to \$9,558,000 during 2002, increasing to 32.4% as a percentage of restaurant sales during 2003 from 30.9% for 2002. The increase is primarily due to an 11% increase in the cost of beef over the prior year, as well as additional costs associated with implementing new menu items and promotions offering certain sandwich items at a discounted price in efforts to increase guest traffic and sales at company-operated restaurants.

Restaurant operating expenses, consisting of labor, supplies, utilities, rent, insurance and certain other unit level operating expenses, increased to \$16,457,000 for 2003 from \$14,536,000 during 2002, increasing as a percentage of restaurant sales to 48.0% from 47.0% in 2002. Labor costs as a percentage of restaurant sales increased by 0.4% primarily due to the implementation of a late-night operations program, requiring an additional investment in labor at the stores. Labor benefit costs have also risen due to increases in health insurance costs. The remainder of the increase is due to higher spending for repairs and maintenance, utilities, insurance and property taxes.

General and administrative costs increased \$98,000 to \$4,533,000 during 2003 from \$4,435,000 in 2002, decreasing as a percentage of total revenue to 11.7% from 12.8% during 2002. Personnel related costs, including recruiting, training and benefit costs, increased by approximately \$200,000 over the prior year. The increase is partially offset by a decrease of \$88,000 in store preopening costs to \$63,000 in 2003 from \$151,000 in 2002.

Advertising expense, which increased to \$2,349,000 for 2003 from \$1,985,000 during 2002, remained relatively flat as a percentage of total revenues at 6.0% in 2003 compared with 5.7% in 2002.

Depreciation expense was \$1,840,000 during 2003 compared with \$1,379,000 during 2002. This increase was primarily related to \$3.3 million in fixed asset additions during 2003 as well as \$4.9 million in fixed asset additions in 2002, primarily related to restaurant growth.

Interest expense decreased 4.8% to \$495,000 for the year ended January 3, 2004 from \$520,000 in the prior year. This decrease primarily results from lower average debt outstanding during 2003. Debt outstanding as of January 3, 2004 was \$5,350,000, a decrease of \$575,000 or 9.7% from the year-earlier period.

Other, net expense was \$67,000 in 2003 compared with \$88,000 in expense for 2002. The company recorded a \$19,000 loss on the disposal of assets during 2002 compared with a \$1,000 gain during 2003. The company also wrote off \$23,000 in deferred loan costs during 2002 for which there were no comparable costs during 2003. These decreases in expense were partially offset by the fact that franchise tax expense increased by \$27,000 for the fifty three weeks ended January 3, 2004, over the year-earlier period. Also included in this category is other miscellaneous income and expenses and these income and expense categories were relatively consistent between the two years.

Income tax expense, which decreased by \$136,000 to \$590,000 from \$726,000 in 2002, decreased as a percentage of pre-tax income at 31.1% in 2003 compared with 33.0% in 2002. The decrease in income tax expense as a percentage of pre-tax income is primarily a result of a \$62,000 work opportunity tax credit earned by the company during 2003.

COMPARISON OF FISCAL YEAR 2002 TO FISCAL YEAR 2001

Restaurant sales at company-operated restaurants increased 12.4% to \$30,951,000 during 2002 from \$27,541,000 during 2001. This increase is primarily the result of a net increase in company-operated restaurants of five stores since December 29, 2001, and a 4% price increase taken by the company in December 2001, offset by the impact of competitive discounting occurring in the last half of 2002.

Franchise and area development fees were \$227,000 during 2002, a decrease of 29.1% from \$320,000 in 2001. Fifteen new franchised restaurants were opened in 2002, compared to thirteen new franchised units opened in 2001. A portion of the decline in fees is attributable to the company recording \$65,000 in fees for the cancellation of franchise and area development agreements in 2001 compared with \$18,000 in 2002. The remaining decline is due to the fact that five of the openings in 2002 were co-branded franchised stores under the company's Multi-Brand Development Agreement with YUM! Brands, Inc., and the fees for these units are lower than traditional stand-alone franchised restaurants.

Royalty fees increased 9.5% to \$2,172,000 during 2002 compared with \$1,984,000 during 2001. The increase is the result of an increase in franchised sales upon which the fees are based. The increase in franchised restaurant sales was due to a net unit growth of ten franchised stores. The increase is partially offset by a decrease of 1.8% in same-store sales for franchised units during 2002.

Advertising fees increased 9.2% to \$548,000 for 2002 compared with \$502,000 during 2001. The increase is primarily due to the increase in franchised restaurant sales, upon which the fees are based.

Cost of restaurant sales, consisting of food, beverage and paper costs, totaled \$9,558,000 during 2002 compared to \$8,797,000 during 2001, decreasing to 30.9% as a percentage of restaurant sales during 2002 from 31.9% for 2001. Product costs remained relatively flat throughout 2002. The decrease in cost of restaurant sales as a percentage of sales is attributable to a 4% menu price increase taken by the company in December of 2001.

Restaurant operating expenses, consisting of labor, supplies, utilities, rent, insurance and certain other unit level operating expenses, increased to \$14,536,000 for 2002 from \$13,027,000 during 2001, decreasing as a percentage of restaurant sales to 47.0% from 47.3% in 2001. Labor costs as a percentage of restaurant sales decreased by 0.8%; however this decrease was partially offset by increased spending for insurance, utilities and property taxes.

General and administrative costs increased \$498,000 to \$4,435,000 during 2002 from \$3,935,000 in 2001, increasing as a percentage of total revenue to 12.8% from 12.6% during 2001. Approximately \$187,000 of the increase was personnel related, including increased spending on recruiting, training and benefit costs. Preopening expenses also increased by \$62,000 due to the expenditures related to the opening of five company-operated restaurants during 2002. The remaining cost increases were related to general increases in spending in the areas of marketing, operations training, information technology and franchisee recruiting during 2002.

Advertising expense, which increased to \$1,985,000 for 2002 from \$1,824,000 during 2001, remained relatively flat as a percentage of total revenues at 5.7% in 2002 compared with 5.9% in 2001.

Depreciation expense was \$1,379,000 during 2002 compared with \$1,383,000 during 2001. The company recorded \$158,000 in goodwill amortization in 2001 compared with zero amortization in 2002 due to the adoption of the Statement of Financial Accounting Standards No. 142, *Goodwill and other Intangible Assets* effective January 1, 2002. This decrease in amortization expense was offset by additional depreciation expense recorded during 2002 for the purchase of additional property and equipment since the prior year.

Interest expense decreased 7.8% to \$520,000 for the year ended December 28, 2002 from \$564,000 in the year-earlier period. While debt outstanding as of December 28, 2002 was \$5,925,000, an increase of \$153,000 on the balance outstanding as of December 29, 2001, the company was able to renegotiate interest rates downward by 1.7% to 2.4% on approximately 45% of its outstanding debt during the fourth quarter of 2001 resulting in the decrease in interest expense for the company in 2002.

Other, net expense was \$88,000 in 2002 compared with \$49,000 in expense for the year ended December 29, 2001. The increase is due to a write-off of \$23,000 of deferred loan costs incurred by the company as well as a net loss on the disposal of assets of \$19,000 compared with a net loss of \$1,000 recognized in the year-earlier period. Also included in this category is other miscellaneous income and expenses, including franchise tax expense and these income and expense categories were relatively consistent during fiscal year 2002 and 2001.

Income tax expense, which increased by \$174,000 to \$726,000 from \$552,000 in 2001, decreased as a percentage of pre-tax income at 33.0% in 2002 compared with 35.0% in 2001. The decrease in income tax expense as a percentage of pre-tax income is primarily a result of the decrease in taxable income.

Impairment of Long-Lived Assets

The company adopted Statement of Financial Accounting Standard ("SFAS") No. 144, *Accounting for the Impairment and Disposal of Long-Lived Assets*, at the beginning of 2002. At each balance sheet date, the company assesses whether there has been impairment in the value of all long-lived assets by determining whether projected undiscounted future cash flows from operations for each restaurant, as defined in SFAS No. 144, exceed its net book value as of the assessment date. A new cost basis is established for impaired assets based on the fair value of these assets as of the date the assets are determined to be impaired.

The company incurred non-cash impairment charges of \$78,000 in the 53 weeks ended January 3, 2004, for the effect of company-operated restaurant closings and impaired assets at company-operated restaurants, of which \$59,000 was related to future lease payments of closed stores, net of estimated sub-lease income and \$19,000 was related to impairments of property and equipment at closed stores.

The company had \$61,000 in reserves for closed properties at the end of fiscal year 2002 of which \$22,000 was charged against the reserve for lease payments. Lease payments of \$39,000 in 2003 were incurred and charged against this additional reserve. As of January 3, 2004, the company's remaining accrual for all future lease obligations discussed above was \$81,000, which is net of estimated sub-lease income.

Liquidity and Capital Resources

Capital expenditures totaled \$3,329,000 in 2003 and \$4,861,000 in 2002. Generally, the company constructs its restaurant buildings on leased properties for its company-operated restaurants. The average monthly lease cost for the 14 company-operated restaurants on leased sites at January 3, 2004 is approximately \$3,300 per month. For the 19 restaurants where the company leases the building as well as the site, the average monthly lease cost is approximately \$5,300.

Cash from operations for the company is primarily affected by net earnings adjusted for deferred franchise fees and non-cash expenses which consist primarily of depreciation and amortization. Depreciation and amortization totaled \$1,840,000 in 2003 and \$1,379,000 in 2002.

Cash provided by operations in 2003 was \$4,816,000 compared with \$3,842,000 in 2002. In recent history, cash from operations and debt have been used for the addition of new restaurants and equipment as well as the re-imaging of existing restaurants to reflect the company's new logo and related color scheme. As of January 3, 2004, the company had total long-term debt of \$5,350,000 and unused lines of credit and loan commitments of potential additional borrowings of \$3,376,000.

On February 11, 2003, the company entered a loan agreement with a financial institution in the amount of \$5,000,000. The loan agreement comprised the following three components: (1) a \$2,500,000 five-year loan with a fixed rate of 5.2%. The funds from the five-year term loan were used to refinance approximately \$2.3 million of existing term loans with an average interest rate of 6.8% and maturity dates ranging from one to two years, (2) a \$2.0 million draw down line for future expansion with a variable rate of interest equal to the one-month LIBOR rate plus a spread not to exceed 3% that is calculated based on certain financial covenants and (3) a \$500,000 revolver line with a variable rate of interest equal to the one-month LIBOR rate plus a spread not to exceed 3% that is calculated based on certain financial covenants. This revolver line replaced the \$750,000 line of credit that was in place as of December 28, 2002. No additional long-term debt commitments were made by the company during the fifty-three weeks ended January 3, 2004.

On January 2, 2001, the company's board of directors adopted a stock repurchase plan that allows the company to repurchase up to 500,000 shares of its outstanding common stock. As of January 3, 2004, the company had repurchased 25,000 shares of common stock under the plan. No further purchases are anticipated in the near term.

The company is budgeting capital expenditures of approximately \$4.0 million in fiscal year 2004, excluding potential acquisitions and share repurchases. These capital expenditures primarily relate to the development of additional company-operated restaurants, the re-imaging of existing restaurants to reflect the company's new logo and related color scheme, store equipment upgrades, and enhancements to existing financial and operating information systems.

The company expects to fund fiscal year 2004 capital expenditures with cash flow from operations and borrowings under the new loan agreement entered in February of 2003. The company believes that existing cash and funds generated from internal operations, as well as borrowings under the new credit facility will meet the company's needs for the foreseeable future.

The company has contractual obligations and commercial commitments including long-term debt, land lease obligations for company-operated restaurants and office space for corporate operations. The table below presents our future contractual obligations (in thousands):

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 years
Long-term debt	\$ 2,539	\$ 729	\$ 1,126	\$ 673	\$ 11
Capital leases	2,811	211	390	319	1,891
Operating leases	7,790	1,460	2,524	1,477	2,329
Purchase obligations	5,410	662	1,198	1,333	2,217
Total contractual obligations	<u>\$ 18,550</u>	<u>\$ 3,062</u>	<u>\$ 5,238</u>	<u>\$ 3,802</u>	<u>\$ 6,448</u>

Qualitative and Quantitative Disclosure about Market Risk

The company is exposed to certain financial market risks, the most predominant being fluctuations in interest rates on variable rate debt and the repricing of fixed rate debt at maturity. Management monitors interest rate fluctuations as an integral part of the company's overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potential adverse effect on our results. The effect of interest rate fluctuations historically has been small relative to other factors affecting operating results, such as food, labor and occupancy costs.

Approximately 10% of the company's debt portfolio as of January 3, 2004, had variable rates or had maturity dates of less than two years. With every 25 basis point increase in interest rates, the company could be subject to additional interest expense of approximately \$1,500 annually, depending on the timing of the rate changes and debt maturities.

The company has considered the use of hedging instruments to minimize interest rate fluctuation risk, but based on the debt portfolio structure described above, no hedging program has been deemed necessary for the company at this time.

Seasonality and Inflation

While the company does not believe that seasonality affects its operations in a materially adverse manner, first quarter results will generally be lower than other quarters due to seasonal climate conditions in the locations of many of its restaurants. Although results were negatively impacted during 2003 due to an 11% increase in the cost of beef, management does not believe that inflation has had a material effect on income during the fifty-three weeks ended January 3, 2004. Increases in food, labor or other operating costs could adversely affect the company's operations. In the past, however, the company generally has been able to increase menu prices or modify its operating procedures to substantially offset increases in its operating costs.

Conversion of Preferred Stock

In accordance with the provisions of the company's Restated Certificate of Incorporation regarding preferred stock, as a result of the company's having attained after-tax net income in excess of \$600,000 during 1994, each share of preferred stock is convertible into one share of common stock, at the option of the holder. The company has notified preferred stockholders of their right to convert preferred stock to common stock and anticipates that all shares of preferred stock will be converted. Such conversion began on April 5, 1995, at which time there were 1,199,979 shares of preferred stock outstanding. As of January 3, 2004, only 19,617 shares have yet to be converted.

Recent Accounting Pronouncements

Note 2 of the Notes to Consolidated Financial Statements discusses new accounting policies adopted by the Company during 2003 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards affects the Company's financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of the Management's Discussion and Analysis and the Notes to Consolidated Financial Statements.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

On an on-going basis, management evaluates company estimates, including those related to bad debts, carrying value of investments in property and equipment, goodwill, income taxes, contingencies and litigation. Management bases company estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition:

Revenue recognition at Company-operated restaurants is straightforward as customers pay for products at the time of sale. The earnings reporting process is covered by the company's system of internal controls and generally does not require significant management judgments and estimates. The company calculates royalty income each week based upon amounts reported by franchisees and provides for estimated losses for revenues that are not likely to be collected. The company maintains these allowances for doubtful accounts for estimated losses resulting from the inability of our franchisees and other borrowers to make required payments. If the financial conditions of our customers or other borrowers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Franchise fees are recognized as revenue when substantially all of the initial services required of the company have been performed, which generally coincides with the opening of the franchises. Such services include training and assistance with site location, equipment vendors, structural design and operating policies. Area development fees arise when franchisees are awarded the right to develop, own and operate additional Back Yard Burgers restaurants in specific geographical areas pursuant to the terms of an Area Development Agreement. Such fees are based on the number of restaurants the franchisee expects to develop. These fees are included as revenue in accordance with the franchise fee recognition policy as each additional restaurant is opened. Under the terms of the franchise and area development agreements, the fees are non-refundable and may be recognized as revenue should the franchisee fail to perform as agreed. Commission costs associated with the sales of franchise and area development rights are expensed when related revenues are recognized.

The company has also collected funds from certain vendors relating to future purchases by the company. The company deferred this amount as other deferred income. These funds are recorded as income in a proportionate manner with respective future purchases. Under the terms of signed contracts, the company is required to purchase specific volumes in future years. If these purchase volumes are not met, the funds related to the volume shortages will be refunded to the vendors.

Long-Lived Assets:

The restaurant industry is capital intensive. The company has approximately 76% of its total assets invested in property and equipment. The company capitalizes only those costs that meet the definition of capital assets under generally accepted accounting principles. Accordingly, repairs and maintenance costs that do not extend the useful life of the asset are expensed as incurred.

The depreciation of our capital assets over their estimated useful lives, and the determination of any salvage values, requires management to make judgments about future events. Because the company utilizes many of its capital assets over relatively long periods, the company periodically evaluates whether adjustments to our estimated lives or salvage values are necessary. The accuracy of these estimates affects the amount of depreciation expense recognized in a period and, ultimately, the gain or loss on the disposal of the asset. Historically, gains and losses on the disposition of assets have not been significant. However, such amounts may differ materially in the future based on restaurant performance, technological obsolescence, regulatory requirements and other factors beyond our control.

Due to the fact that the company invests a significant amount in the construction or acquisition of new restaurants, the company has risks that these assets will not provide an acceptable return on our investment and an impairment of these assets may occur. The accounting test for whether an asset held for use is impaired involves first comparing the carrying value of the asset with its estimated future undiscounted cash flows. If these cash flows do not exceed the carrying value, the asset must be adjusted to its current fair value. The company periodically performs this test on each of our restaurants to evaluate whether impairment exists. Factors influencing our judgment include the age of the restaurant (new restaurants have significant start up costs which impede a reliable measure of cash flow), estimation of future restaurant performance and estimation of restaurant fair value. Due to the fact that the management can specifically evaluate impairment on a restaurant by restaurant basis, the company has historically been able to identify impaired restaurants and record the appropriate adjustment.

The company has approximately \$1.8 million of goodwill on our balance sheet resulting from the acquisition of businesses. New accounting standards adopted in 2002 require that we review goodwill for impairment on an annual basis and cease all goodwill amortization. The adoption of these new rules did not result in an impairment of our recorded goodwill. The annual evaluation of goodwill impairment requires a two-step test in which the market value of the company is compared to the recorded book value. If the market value is less than the book value, goodwill impairment is recorded. Once an impairment of goodwill has been recorded, it cannot be reversed.

Deferred Income Taxes:

The company records income tax liabilities utilizing known obligations and estimates of potential obligations. A deferred tax asset or liability is recognized whenever there are future tax effects from existing temporary differences and operating loss and tax credit carryforwards. The company records a valuation allowance to reduce deferred tax assets to the balance that is more likely than not to be realized. In evaluating the need for a valuation allowance, management must make judgments and estimates on future taxable income, feasible tax planning strategies and existing facts and circumstances. When management determines that deferred tax assets could be realized in greater or less amounts than recorded, the asset balance and income statement reflect the change in the period such determination is made. Based on management's estimates, there is presently a \$394,000 valuation allowance recorded on the company's deferred tax assets. However, changes in facts and circumstances that affect our judgments or estimates in determining the proper deferred tax assets or liabilities could materially affect the recorded amounts.

Off-Balance Sheet Arrangements

At January 3, 2004, the company had a guarantee of a franchisee loan relating to the acquisition of a parcel of land and the construction of a building that is currently being operated as a Back Yard Burgers franchised location. The original loan balance was \$655,000 and the balance as of January 3, 2004, was approximately \$500,000.

Known Trends and Uncertainties

Labor will continue to be a critical factor in the foreseeable future. In most areas where the company operates restaurants, there is a shortage of suitable labor. This, in itself, could result in higher wages as the competition for employees intensifies, not only in the restaurant industry, but in practically all retail and service industries. It is crucial for the company to develop and maintain programs to attract and retain quality employees. During 2003, the cost of beef increased approximately 11% over the prior year while the cost of chicken was relatively stable. In light of what appeared to be a sustained period of increased beef costs, the company implemented menu price increases of approximately 2% effective October 12, 2003 in order to partially offset these increased costs. It may be difficult to raise menu prices to fully cover any future cost increases. Additional margin improvements will have to be made through operational improvements, equipment advances and increased volumes to help offset these increases, due to the competitive state of the quick-service restaurant industry.

Due to the competitive nature of the restaurant industry, site selection continues to be challenging as the number of businesses vying for locations with similar characteristics increases. This will likely result in higher occupancy costs for prime locations.

Company-operated same-store sales increased 2.6% during 2003 compared with a 0.1% increase in 2002. Franchised same-store sales decreased 4.2% during 2003 compared with a 1.8% decrease in 2002. Management attributes the decline in same-store sales for franchised locations to competitive discounting. The impact of competitive discounting on company-operated same-store sales was offset by certain initiatives undertaken by management during 2003, including the re-imaging of existing company-operated restaurants to reflect the company's new logo and related color scheme, promotional incentives intended to increase traffic and sales and the testing of a late-night operations program at company-operated restaurants.

Management intends to continue with its marketing strategy of enhancing the company's points of differentiation and further positioning the company as a premium fast-food provider. The future success of the company will be determined, to a great extent, by the ability to positively address these issues.

BACK YARD BURGERS, INC.**Consolidated Balance Sheets**

(in thousands, except for share and per share amounts)

	January 3, 2004	December 28, 2002
ASSETS		
Cash and cash equivalents	\$ 2,292	\$ 1,406
Receivables, less allowance for doubtful accounts of \$65 and \$80	789	495
Inventories	251	276
Income taxes receivable	--	296
Current deferred tax asset	143	170
Prepaid expenses	58	53
Total current assets	3,533	2,696
Property and equipment, at depreciated cost	18,717	17,247
Goodwill	1,751	1,751
Noncurrent deferred tax asset	25	12
Notes receivable	97	110
Other assets	377	251
Total assets	\$ 24,500	\$ 22,067
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 1,371	\$ 1,479
Accrued expenses	2,101	1,483
Reserve for closed stores	81	61
Current installments of long-term debt	940	825
Income tax payable	141	--
Total current liabilities	4,634	3,848
Long-term debt, less current installments	4,410	5,100
Deferred franchise and area development fees	1,200	504
Other deferred income	520	272
Other deferred liabilities	49	59
Total liabilities	10,813	9,783
Commitments and contingencies (Note 16)		
Stockholders' equity		
Preferred stock, \$.01 par value; 2,000,000 shares authorized; 19,617 shares issued and outstanding	--	--
Common stock, \$.01 par value; 12,000,000 shares authorized; 4,748,948 and 4,720,739 shares issued and outstanding	48	48
Paid-in capital	10,504	10,410
Treasury stock, at cost, 25,000 shares	(28)	(28)
Retained earnings	3,163	1,854
Total stockholders' equity	13,687	12,284
Total liabilities and stockholders' equity	\$ 24,500	\$ 22,067

See accompanying notes to consolidated financial statements.

BACK YARD BURGERS, INC.**Consolidated Statements of Operations**

(in thousands, except per share amounts)

	Years Ended		
	January 3, 2004	December 28, 2002	December 29, 2001
Revenues:			
Restaurant sales	\$ 34,279	\$ 30,951	\$ 27,541
Franchise and area development fees	378	227	320
Royalty fees	2,621	2,172	1,984
Advertising fees	661	548	502
Other	890	789	791
Total revenues	<u>38,829</u>	<u>34,687</u>	<u>31,138</u>
Expenses:			
Cost of restaurant sales	11,117	9,558	8,797
Restaurant operating expenses	16,457	14,536	13,027
General and administrative	4,533	4,435	3,935
Advertising	2,349	1,985	1,824
Depreciation	1,840	1,379	1,383
Impairment of long-lived assets	78	--	--
Total expenses	<u>36,374</u>	<u>31,893</u>	<u>28,966</u>
Operating income	<u>2,455</u>	<u>2,794</u>	<u>2,172</u>
Interest income	6	17	20
Interest expense	(495)	(520)	(564)
Other, net	(67)	(88)	(49)
Income before income taxes	<u>1,899</u>	<u>2,203</u>	<u>1,579</u>
Income tax expense	590	726	552
Net income	<u>\$ 1,309</u>	<u>\$ 1,477</u>	<u>\$ 1,027</u>
Income per share:			
Basic	<u>\$ 0.28</u>	<u>\$ 0.31</u>	<u>\$ 0.22</u>
Diluted	<u>\$ 0.26</u>	<u>\$ 0.29</u>	<u>\$ 0.22</u>
Weighted average number of common shares and common equivalent shares outstanding:			
Basic	<u>4,732</u>	<u>4,709</u>	<u>4,635</u>
Diluted	<u>5,053</u>	<u>5,058</u>	<u>4,757</u>

See accompanying notes to consolidated financial statements.

BACK YARD BURGERS, INC.

Consolidated Statements of Changes in Stockholders' Equity

(in thousands, except for number of shares)

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Treasury Stock</u>		<u>Paid-in</u>	<u>Retained</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Capital</u>	<u>Earnings/</u>	<u>Total</u>
								<u>(Deficit)</u>	
Balance at year ended December 30, 2000	19,763	--	4,646,103	47	--	--	10,158	(650)	9,555
Employee stock purchases			17,776	--			26		26
Treasury stock purchases			(25,000)	--	25,000	(28)			(28)
Exercise of stock options			6,140	--			11		11
Net income								1,027	1,027
Balance at year ended December 29, 2001	19,763	--	4,645,019	47	25,000	(28)	10,195	377	10,591
Conversion of preferred stock	(146)		146						
Employee stock purchases			6,558	--			29		29
Exercise of stock options			69,016	1			186		187
Net income								1,477	1,477
Balance at year ended December 28, 2002	19,617	--	4,720,739	48	25,000	(28)	10,410	1,854	12,284
Employee stock purchases			6,867	--			30		30
Exercise of stock options			21,342	--			64		64
Net income								1,309	1,309
Balance at year ended January 3, 2004	<u>19,617</u>	<u>\$ --</u>	<u>4,748,948</u>	<u>\$ 48</u>	<u>25,000</u>	<u>\$ (28)</u>	<u>10,504</u>	<u>3,163</u>	<u>13,687</u>

See accompanying notes to consolidated financial statements.

BACK YARD BURGERS, INC.
Consolidated Statements of Cash Flows
(in thousands)

	Years Ended		
	January 3, 2004	December 28, 2002	December 29, 2001
Cash flows from operating activities:			
Net income	\$ 1,309	\$ 1,477	\$ 1,027
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of property and equipment	1,840	1,379	1,225
Impairment of long-lived assets	78	--	--
Deferred income taxes	14	423	359
Amortization of intangible assets	--	--	158
Provision for losses on receivables	--	(49)	291
(Gain)/loss on sale of assets	(1)	19	1
Other deferred income	248	(69)	(116)
Changes in assets and liabilities:			
Receivables	(294)	136	(321)
Inventories	25	(47)	(21)
Prepaid expenses and other current assets	(5)	(3)	8
Other assets	8	35	(17)
Accounts payable and accrued expenses	510	600	600
Reserve for closed stores	(39)	(22)	54
Income taxes payable/receivable	437	(258)	(67)
Other deferred liabilities	(10)	2	(11)
Deferred franchise and area development fees	696	219	(174)
Net cash provided by operating activities	4,816	3,842	2,996
Cash flows from investing activities:			
Additions to property and equipment	(3,329)	(4,861)	(2,791)
Proceeds from sale of property and equipment	1	375	13
Investment in joint ventures	(108)	--	--
Proceeds on notes receivable	13	24	20
Net cash used in investing activities	(3,423)	(4,462)	(2,758)
Cash flows from financing activities:			
Issuance of stock	94	216	37
Principal payments on short-term debt	(300)	--	--
Proceeds from issuance of short-term debt	300	--	--
Principal payments on long-term debt	(3,075)	(587)	(803)
Proceeds from issuance of long-term debt	2,500	740	1,172
Treasury stock purchases	--	--	(28)
Loan fees paid	(26)	--	--
Net cash (used) provided by financing activities	(507)	369	378
Net increase (decrease) in cash and cash equivalents	886	(251)	616
Cash and cash equivalents:			
Beginning of year	1,406	1,657	1,041
End of year	\$ 2,292	\$ 1,406	\$ 1,657
Supplemental disclosure of cash flow information:			
Income taxes paid	\$ 139	\$ 561	\$ 260
Interest paid	\$ 500	\$ 531	\$ 560
Noncash investing and financing activities:			
Assumption of collateral underlying note receivable	\$ --	\$ --	\$ 55

See accompanying notes to consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business Activity. Back Yard Burgers, Inc. (the "company") owns and operates quick-service and fast-casual restaurants and is engaged in the sale of franchises in Back Yard Burgers and the collection of royalties based upon related franchise sales. The company grants franchise rights for the use of the "Back Yard Burgers" trade name and other associated trademarks, signs, emblems, logos, slogans and service marks which have been or may be developed. At January 3, 2004, the company operated 42 restaurants in four states (Missouri, Mississippi, Arkansas and Tennessee) and franchised 90 restaurants in 17 states.

Consolidation Policy. The financial statements include the accounts of Back Yard Burgers, Inc. and its wholly owned subsidiaries, Little Rock Back Yard Burgers, Inc., BYB Properties, Inc. and Atlanta Burgers BYB Corporation, as well as Back Yard Burgers National Advertising Fund. All intercompany transactions have been eliminated.

Fiscal Year. The company maintains its financial records on a 52-53 week fiscal year ending on the Saturday closest to December 31. The year ended January 3, 2004 was a 53 week year and the years ended December 28, 2002 and December 29, 2001 were 52 week years.

Use of Estimates. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents. The company considers cash on hand, deposits in banks and short-term investments with an original maturity of less than three months when purchased as cash and cash equivalents.

Inventories. Inventories primarily consist of food and beverage products and are valued at the lower of cost or market; cost is determined by the first-in, first-out ("FIFO") method.

Income Taxes. Deferred income taxes are provided for the tax effects of temporary differences between the financial reporting basis and the income tax basis of the company's assets and liabilities.

Other Deferred Income. The Company adopted EITF 02-16 *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor* effective December 29, 2002. EITF 02-16 concluded that cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement. The Company previously recorded volume-based incentives as other revenues. The Company will record volume-based incentives related to company operated stores as a reduction of cost of restaurant sales for all contracts or agreements entered into after December 28, 2002.

During 2003, the company received funds from certain vendors relating to future purchases by the company. The company deferred this amount as other deferred income. These funds are recorded as income in a proportionate manner with respective future purchases. Under the terms of signed contracts, the company is required to purchase specific volumes in future years. If these purchase volumes are not met, the funds related to the volume shortages will be refunded to the vendors. The company recognized approximately \$79,000 in 2003 as a reduction of cost of restaurant sales pursuant to this arrangement.

The company recognized approximately \$321,000, \$282,000 and \$309,000 as other revenue in 2003, 2002 and 2001, respectively, pursuant to similar arrangements.

Franchise and Area Development Fee Income. Franchise fees are recognized as revenue when substantially all of the initial services required of the company have been performed, which generally coincides with the opening of the franchises. Such services include training and assistance with site location, equipment vendors, structural design and operating policies. Area development fees arise when franchisees are awarded the right to develop, own and operate additional Back Yard Burgers restaurants in specific geographical areas pursuant to the terms of an Area Development Agreement. Such fees are based on the number of restaurants the franchisee expects to develop. These fees are included as revenue in accordance with the franchise fee recognition policy as each additional restaurant is opened.

Under the terms of the franchise and area development agreements, the fees are non-refundable and may be recognized as revenue should the franchisee fail to perform as agreed. Commission costs associated with the sales of franchise and area development rights are expensed when related revenues are recognized.

Royalty and Advertising Fee Income. As part of its franchise agreements, the company receives a percentage of each unit's gross sales (generally 4%). The franchise agreements also provide that franchisees are required to pay an additional 1% of gross sales to the National Advertising Fund (see Note 13). These fees are recorded on the accrual basis of accounting.

Other Revenue. Other revenue is primarily comprised of sales of proprietary food products to franchisees, volume based incentive receipts under long-term contracts with vendors entered into before December 29, 2002 and contributions to the National Advertising Fund by certain of our vendors based upon purchasing volumes of the Company and our franchisees. Revenue from sales of proprietary food products is recognized when the products are shipped. Volume based revenue and contributions from our vendors are recognized systematically throughout the accounting period based on the estimated annual volume to be achieved under the agreements.

Restaurant Operating Expenses. Restaurant operating expenses include all costs associated with the operation of the restaurant except corporate overhead, advertising, depreciation and amortization.

Property and Equipment. Property and equipment is recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the respective assets. Leasehold costs and improvements are amortized over the lesser of their estimated useful lives or the remaining lease term. The average depreciable lives are as follows: buildings and building and site improvements - 15 to 25 years; fixtures and equipment - 3 to 7 years; and transportation vehicles - 3 to 5 years.

Preopening costs. The company expenses preopening costs as incurred. Preopening costs expensed for fiscal years 2003, 2002 and 2001 were approximately \$63,000, \$151,000 and \$89,000, respectively.

Advertising Costs. Advertising costs, including production costs, are charged to expense as incurred on the first date of the advertising period.

Intangible assets. As of January 1, 2002, the company adopted Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets*. Under SFAS 142, goodwill is no longer amortized but is tested for impairment using a fair value approach, at the "reporting unit" level. A reporting unit is the operating segment, or a business one level below that operating segment (the "component" level) if discrete financial information is prepared and regularly reviewed by management at the component level. The company has determined that it operates as one segment and one reporting unit because the operations of the restaurants are homogeneous and discrete financial information of different segments or reporting units is not prepared and regularly reviewed by management.

SFAS 142 requires a two-step process for testing impairment. First, the fair value the company is compared to its carrying value to determine whether an indication of impairment exists. Market capitalization is used to determine the fair value of the company. If an impairment is indicated, then the fair value of the goodwill is determined by allocation of the company's fair value to its assets and liabilities (including any unrecognized intangible assets) as if the company had been acquired in a business combination. The amount of impairment for goodwill and other intangible assets is measured as the excess of its carrying value over its fair value. As required by SFAS No. 142, the company completed a transitional impairment test for goodwill as of January 1, 2002, and also an impairment test as of December 29, 2002, and January 3, 2004. Based on the results of these tests, the company did not record any impairment of our goodwill.

The company has no intangible assets other than goodwill.

Before January 1, 2002, the company amortized goodwill over its estimated period of benefit on a straight-line basis not to exceed 40 years. When an intangible asset's carrying value exceeded associated expected operating cash flows, we considered it to be impaired and wrote it down to fair value, which we determined based on either discounted future cash flows or appraised values. In accordance with SFAS 142, The company ceased amortization of goodwill in 2002. Accumulated amortization of goodwill totaled \$908,000 prior to the cessation of goodwill amortization.

Impairment of Long-Lived Assets. The company adopted Statement of Financial Accounting Standard ("SFAS") No. 144, *Accounting for the Impairment and Disposal of Long-Lived Assets*, at the beginning of 2002. At each balance sheet date, the company assesses whether there has been impairment in the value of all long-lived assets by determining whether projected undiscounted future cash flows from operations for each restaurant, as defined in SFAS No. 144, exceed its net book value as of the assessment date. A new cost basis is established for impaired assets based on the fair value of these assets as of the date the assets are determined to be impaired.

The company incurred non-cash impairment charges of \$78,000 in the 53 weeks ended January 3, 2004, for the effect of company-operated restaurant closings and impaired assets at company-operated restaurants, of which \$59,000 was related to future lease payments of closed stores, net of estimated sub-lease income and \$19,000 was related to impairments of property and equipment at closed stores.

The company had \$61,000 in reserves for closed properties at the end of fiscal year 2002 of which \$22,000 was charged against the reserve for lease payments. Lease payments of \$39,000 in 2003 were incurred and charged against this additional reserve. As of January 3, 2004, the company's remaining accrual for all future lease obligations discussed above was \$81,000, which is net of estimated sub-lease income.

Preferred Stock. In accordance with the provisions of the company's Restated Certificate of Incorporation regarding preferred stock, each share of preferred stock is convertible into one share of common stock, at the option of the holder. As of January 3, 2004, all but 19,617 shares of preferred stock had been converted to common stock.

Earnings Per Share. The company calculates earnings per share in accordance with Statement of Financial Accounting Standards No. 128, *Earnings per Share*, which requires the presentation of basic and diluted earnings per share. Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity (Note 15).

Stock-Based Employee Compensation. The company applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its plans. Accordingly, no compensation expense has been recognized for its stock-based compensation. Had compensation cost for the company's stock option plan been determined based on the fair value at the grant date for awards in 2002, 2001 and 2000 under the plan consistent with the fair value method prescribed by SFAS No. 123, *Accounting for Stock-Based Compensation*, the company's operating results for 2003, 2002 and 2001 would have been reduced to the pro forma amounts indicated below (in thousands, except per share data):

	2003	2002	2001
Net income:			
As reported	\$ 1,309	\$ 1,477	\$ 1,027
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all rewards, net of related taxes	(181)	(252)	(73)
Pro forma	1,128	1,225	954
Basic earnings per share:			
As reported	0.28	0.31	0.22
Pro forma	0.24	0.26	0.21
Diluted earnings per share:			
As reported	0.26	0.29	0.22
Pro forma	0.22	0.24	0.20

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions using grants in 2003, 2002 and 2001, respectively:

	2003	2002	2001
Average expected life (years)	5.0	5.0	5.0
Average expected volatility	74.9%	74.7%	62.2%
Risk-free interest rates	3.4%	4.6%	5.0%
Dividend yield	0.0%	0.0%	0.0%

The pro forma results reported above will not be representative of the effect on operating results for future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

Fair Value of Financial Instruments. At January 3, 2004, the company did not have outstanding any financial derivative instruments. The carrying amounts of cash and receivables approximate fair value because of the short maturity of those instruments. The fair value of the company's long-term debt is estimated based on the current borrowing rates available to the company for bank loans with similar terms and average maturities. At January 3, 2004, the fair value was approximately \$6.0 million.

NOTE 2 – RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46 ("FIN 46"), *Consolidation of Variable Interest Entities ("VIEs")*, an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to improve financial reporting of special purpose and other entities. In accordance with the interpretation, business enterprises that represent the primary beneficiary of another entity by retaining a controlling financial interest in that entity's assets, liabilities, and results of operating activities must consolidate the entity in their financial statements. Prior to the issuance of FIN 46, consolidation generally occurred when an enterprise controlled another entity through voting interests. Certain VIEs that are qualifying special purpose entities ("QSPEs") subject to the reporting requirements of SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, will not be required to be consolidated under the provisions of FIN 46. The consolidation provisions of FIN 46 apply to VIEs created or entered into after January 31, 2003, and for pre-existing VIEs in the first reporting period ending after December 15, 2003. If applicable, transition rules allow the restatement of financial statements or prospective application with a cumulative effect adjustment. In addition, FIN 46 expands the disclosure requirements for the beneficiary of a significant or a majority of the variable interests to provide information regarding the nature, purpose and financial characteristics of the entities. As of January 3, 2004, the Company has evaluated the impact of FIN 46 and does not believe that implementation of this interpretation will have a material effect on its financial statements.

NOTE 3 - ACCOUNTS RECEIVABLE

Corporate receivables and National Advertising Fund receivables represent amounts due from franchisees for contractual obligations and for product purchases. A summary of accounts receivable follows (in thousands):

	January 3, 2004	December 28, 2002
Corporate receivables	\$ 221	\$ 204
National Advertising Fund receivables	74	66
Credit card receivables	74	30
Rebate receivables	165	201
Insurance claim receivables	198	--
Other	122	74
	<u>854</u>	<u>575</u>
Allowance for doubtful receivables	(65)	(80)
	<u>\$ 789</u>	<u>\$ 495</u>

NOTE 4 - PROPERTY AND EQUIPMENT

Summaries of property and equipment follow (in thousands):

	January 3, 2004	December 28, 2002
Land	\$ 3,856	\$ 3,856
Buildings	11,341	9,712
Building and site improvements	3,174	3,135
Fixtures and equipment	10,779	9,234
Transportation Vehicles	383	303
	<u>29,533</u>	<u>26,240</u>
Accumulated depreciation and amortization	(10,816)	(8,993)
	<u>\$ 18,717</u>	<u>\$ 17,247</u>

Approximately \$4.5 million and \$4.4 million of the total fixed assets above relate to assets, primarily buildings, previously acquired with capital leases and held by the company for fiscal years 2003 and 2002, respectively. Related accumulated depreciation for these assets was approximately \$1.1 million and \$0.8 million for fiscal years 2003 and 2002, respectively.

NOTE 5 - INVESTMENT IN JOINT VENTURES

As of December 28, 2003, the company had invested a total of \$200,000 for 23%-25% interests in four joint ventures for the purpose of operating Back Yard Burgers restaurants. The company invested an additional \$108,000 in one of the joint ventures during the 53 weeks ended January 3, 2004, for the purpose of paying down the debt of the joint venture. Two of the joint ventures purchased the building and land from the company. No gain or loss was recorded by the company in connection with these sales. Two joint ventures purchased land from a third party and built a building. The company then entered into a long-term lease with each joint venture. Three of the leases are accounted for as capital lease obligations and the fixed assets are recorded on the company's balance sheet along with the present value of the future lease commitments. The remaining lease is accounted for as an operating lease. The company has guaranteed 23%-25% of the long-term debt obtained by the joint ventures to finance the construction of the restaurants. At January 3, 2004, approximately \$104,000 of such debt is guaranteed by the company.

Each of the above investments is recorded at cost as there is no material difference between the cost and equity method of accounting for any of these investments.

NOTE 6 - ACCRUED EXPENSES

Summaries of accrued expenses follow (in thousands):

	January 3, 2004	December 28, 2002
Payroll related	\$ 776	\$ 895
Equipment	627	3
Sales taxes	302	240
Property taxes	125	146
Interest	39	44
Utilities	19	40
Other miscellaneous accruals	213	115
	<u>\$ 2,101</u>	<u>\$ 1,483</u>

NOTE 7 - DEFERRED FRANCHISE AND AREA DEVELOPMENT FEES

At January 3, 2004 deferred fees received for certain franchise and area development rights, net of commissions paid, include amounts sold during the following years (in thousands):

2003	\$ 982
Previous years	218
	<u>\$ 1,200</u>

NOTE 8 – INDEBTEDNESS

Long-term debt is collateralized by property and equipment with a net book value aggregating \$8,890,000 and a portion is guaranteed by the personal endorsements of certain stockholders. The balances consist of the following (in thousands):

	January 3, 2004	December 28, 2002
Notes payable to financial institutions, payable in monthly installments ranging from \$1,942 to \$47,486, including interest ranging from 5.2%	\$ 2,220	\$ 2,412
Capital lease obligations, payable in monthly installments ranging from \$4,650 to \$4,850, and effective interest rates ranging from 8.7% to 8.9%	1,331	1,383
Equipment-related capital lease obligations, payable in monthly installments ranging from \$4,645 to \$5,049, and effective interest rates ranging from 7.9% to 9.4%	282	370
Capital lease obligations to Lester's Back Yard Burgers Joint Venture I, II and IV (See Note 5), payable in monthly installments ranging from \$3,883 to \$7,009 and effective interest rates ranging from 12.0% to 12.5%	1,198	1,257
Notes payable to a leasing company, payable in monthly installments ranging from \$1,122 to \$5,643, including interest of 14.1%	319	503
	5,350	5,925
	(940)	(825)
Less current installments	\$ 4,410	\$ 5,100
Total		

The principal maturities of all long-term debt outstanding as of January 3, 2004, are as follows: \$940,000 in 2004, \$794,000 in 2005, \$722,000 in 2006, \$748,000 in 2007, \$246,000 in 2008 and \$1,900,000 thereafter.

On February 11, 2003, the company entered a loan agreement with a financial institution in the amount of \$5,000,000. The loan agreement comprised the following three components: (1) a \$2,500,000 five-year loan with a fixed rate of 5.2%. The funds from the five-year term loan were used to refinance approximately \$2.3 million of existing notes payable to financial institutions with an average interest rate of 6.8% and maturity dates ranging from one to two years, (2) a \$2.0 million draw down line for future expansion with a variable rate of interest equal to the one month LIBOR rate plus a spread not to exceed 3% that is calculated based on certain financial covenants and (3) a \$500,000 revolver line with a variable rate of interest equal to the one month LIBOR rate plus a spread not to exceed 3% that is calculated based on certain financial covenants, the most restrictive requiring the company to maintain a debt coverage ratio of at least 1.5 to 1.0. As of January 3, 2004, the company's debt coverage ratio was 2.9 to 1.0. The revolver line replaced the \$750,000 line of credit that was in place as of December 28, 2002.

The company has three capital lease obligations relating to three buildings in which the company operates restaurants. Two of these obligations were entered during fiscal year 2001 and the third entered during fiscal year 2002. All three of these leases have an initial term of 15 years with a minimum of four 5-year renewal options at the discretion of the company.

The company also has two capital lease obligations relating to the acquisition of certain restaurant equipment. One of these leases was entered in September of 2000 and the other in October of 2002, both having lease terms of 60 months.

On October 4, 1996, the company received a commitment (the "Commitment") from a leasing company for a loan transaction. The Commitment provides the company with up to \$2,000,000 and bears interest of approximately 14.1%. The Commitment is secured by certain real and personal property to be constructed and/or acquired with the commitment proceeds. As of January 3, 2004, borrowings outstanding under the commitment are \$319,000, and \$876,000 is available under the commitment.

NOTE 9 - OPERATING LEASES

Operating leases relate to leased land sites for company-operated restaurants and office space for corporate operations. All leases contain renewal options. The future minimum rental payments under operating lease agreements as of January 3, 2004 are as follows (in thousands):

2004	\$ 1,460
2005	1,341
2006	1,183
2007	827
2008	650
Thereafter	2,329
	<u>\$ 7,790</u>

Rent expense was \$1,465,000, \$1,358,000 and \$1,255,000 in 2003, 2002 and 2001, respectively.

NOTE 10 - RELATED PARTY TRANSACTIONS

In July of 2002, the company entered into a financing transaction for a new restaurant site and building with certain officers and directors of the company. The total value of the transaction was \$840,000. The company recorded \$490,000 as a capital lease for the construction of the building and \$350,000 as an operating lease for the land on which the building is located. The effective interest rate of the transaction was approximately 8.7%. The transaction was reviewed and approved by the company's board of directors.

NOTE 11 - GOODWILL

There was no change in the carrying amount of goodwill during the year ended January 3, 2004.

The following schedule adjusts reported net income to exclude amortization expense (net of income taxes) related to goodwill (in thousands):

	<u>Years Ended</u>		
	<u>January 3, 2004</u>	<u>December 28, 2002</u>	<u>December 29, 2001</u>
Net income			
Reported net income	\$1,309	\$1,477	\$1,027
Add back: Goodwill amortization	--	--	103
Adjusted net income	<u>\$1,309</u>	<u>\$1,477</u>	<u>\$1,130</u>
Basic earnings per share:			
Reported net income	\$ 0.28	\$ 0.31	\$ 0.22
Goodwill amortization	--	--	0.02
Adjusted net income	<u>\$ 0.28</u>	<u>\$ 0.31</u>	<u>\$ 0.24</u>
Diluted earnings per share:			
Reported net income	\$ 0.26	\$ 0.29	\$ 0.22
Goodwill amortization	--	--	0.02
Adjusted net income	<u>\$ 0.26</u>	<u>\$ 0.29</u>	<u>\$ 0.24</u>

NOTE 12 - INCOME TAXES

Income tax expense for the following tax years is comprised of (in thousands):

	2003	2002	2001
Federal, current	\$ 569	\$ 303	\$ 193
State, current	7	--	--
Federal, deferred	14	423	359
	<u>\$ 590</u>	<u>\$ 726</u>	<u>\$ 552</u>

Deferred income taxes are provided in recognition of the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

The deferred tax assets (liabilities) comprise the following (in thousands):

	January 3, 2004	December 28, 2002
<u>Current</u>		
Current deferred tax assets:		
Allowance for doubtful receivable	\$ 22	\$ 27
Accrued expenses	82	128
Other	39	15
	<u>143</u>	<u>170</u>
Current deferred tax liabilities	--	--
Net current deferred tax asset	<u>\$ 143</u>	<u>\$ 170</u>
<u>Noncurrent</u>		
Noncurrent deferred tax assets:		
Franchise fees	\$ 129	\$ 71
Net operating loss carryforwards	394	432
Alternative minimum tax credit carryforwards	--	--
Goodwill amortization	54	111
Other deferred income	43	93
Other	321	129
Gross noncurrent deferred tax assets	<u>941</u>	<u>836</u>
Noncurrent deferred tax liabilities:		
Depreciation	<u>(522)</u>	<u>(392)</u>
Gross noncurrent deferred tax liabilities	<u>(522)</u>	<u>(392)</u>
Net noncurrent deferred tax assets	419	444
Deferred tax asset valuation allowance	<u>(394)</u>	<u>(432)</u>
	<u>\$ 25</u>	<u>\$ 12</u>

The ultimate realization of these assets is dependent upon the generation of future taxable income sufficient to offset the related deductions and loss carryforwards within the applicable carryforward period. The company evaluates the need for a valuation allowance and, based on the weight of available evidence, has determined that it is more likely than not that certain deferred tax assets will eventually be realized. The valuation allowance reflected above is based on management's conclusion that it is more likely than not that certain state tax carryforward items will expire unused.

A reconciliation of the statutory Federal and State income tax rates to the income tax provision is as follows:

	2003		2002		2001	
	Amount	%	Amount	%	Amount	%
Computed "expected" tax	\$ 673	35.4	\$ 771	35.0	\$ 552	35.0
Goodwill amortization	--	0.0	--	0.0	15	1.0
Work opportunity tax credit	(62)	(3.2)	--	0.0	--	0.0
Other	(21)	(1.1)	(45)	(2.0)	(15)	(1.0)
	<u>\$ 590</u>	<u>31.1</u>	<u>\$ 726</u>	<u>33.0</u>	<u>\$ 552</u>	<u>35.0</u>

As of January 3, 2004, the company has net operating loss carryforwards available for state income tax reporting purposes on a consolidated basis of approximately \$9.8 million. These net operating loss carryforwards expire between 2004 and 2018.

NOTE 13 - NATIONAL ADVERTISING FUND

As part of the standard franchise agreement, each operating unit contributes 1% of its sales to a National Advertising Fund. Under the terms of the agreement, at least 50% of these funds must be spent on the creation of marketing tools, such as advertising copy for use on local radio and television and other collateral material for the operating units. As a general rule, the funds are not used for the purchase and placement of media advertising. The remaining funds are available for use by the company on such items as testing and development of new products, investigating improvements in operating methods, or other purposes that the company shall deem to be in the interest of improving operations and earnings of the company and its franchisees.

NOTE 14 - STOCK OPTION AND BENEFIT PLANS

In 1992, the Board of Directors of the company and the shareholders authorized the adoption of an Incentive Stock Option Plan ("ISOP") for the company's employees. As amended in 1993, an aggregate of 176,969 shares of common stock may be granted under the ISOP. Options granted under the ISOP may not be granted at a price less than the fair market value of the common stock on the date of grant (or 110% of fair market value in the case of persons holding 10% or more of the voting stock of the company). The aggregate fair market value of shares for which options are granted to any employee during any calendar year may not exceed \$100,000. The options expire ten years from the date of grant.

In May 1995, the Board of Directors of the company and the shareholders authorized the adoption of an Incentive Award Plan ("IAP") for the company's employees. An aggregate of 450,000 shares of common stock may be granted under the IAP, as amended in May 1997. Options granted under the IAP may be designated by the Compensation Committee of the Board of Directors as Incentive Stock Options or Non-Qualified Stock Options. Non-Qualified Stock Options granted under the IAP may not be granted at a price less than par value of the common stock. Incentive Stock Options granted under the IAP may not be granted at a price less than the fair market value of the common stock on the date of grant (or 110% of fair market value in the case of persons holding 10% or more of the voting stock of the company). The aggregate fair market value of shares for which options are granted to any employee during any calendar year may not exceed \$100,000. The term of the options shall be set by the Compensation Committee of the Board of Directors and no term shall exceed a reasonable time period. In the case of Incentive Stock Options, the term shall not be more than ten years from the date of grant.

Under the IAP, the Compensation Committee of the Board of Directors may award Restricted Stock and/or a Performance Award to selected employees. A Performance Award shall mean cash bonus, stock bonus or other performance or incentive award that is paid in cash, stock or a combination of both. The company has not issued any Restricted Stock or Performance Awards.

In May 2002, the Board of Directors of the company and the shareholders authorized the adoption of an Equity Incentive Plan ("EIP") for the company's employees and directors. An aggregate of 225,000 shares of common stock may be granted under the EIP. Options granted under the EIP may be designated by the Compensation Committee of the Board of Directors as Incentive Stock Options or Non-Qualified Stock Options. Non-Qualified Stock Options granted under the EIP may be granted at a price less than fair market value of the common stock on the grant date. Incentive Stock Options granted under the EIP may not be granted at a price less than the fair market value of the common stock on the date of grant (or 110% of fair market value in the case of persons holding 10% or more of the voting stock of the company). The aggregate number of shares for which

Awards are granted to any employee during any calendar year may not exceed 35,000. The term of the options shall be set by the Compensation Committee of the Board of Directors and shall not be more than ten years from the date of grant.

Additionally, under the EIP, the Compensation Committee of the Board of Directors may award Restricted Stock and/or stock appreciation rights (SARs) to selected employees. The company has not issued any Restricted Stock or SARs.

A summary of activity in the above option plans for the years ended January 3, 2004, December 28, 2002, and December 29, 2001 follows:

	2003		2002		2001	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	498,961	\$ 2.58	440,967	\$ 1.86	346,635	\$ 2.32
Granted	223,000	4.93	131,000	5.03	146,000	0.86
Exercised	(21,342)	3.03	(69,016)	2.59	(6,140)	1.78
Canceled	(41,568)	4.63	(3,990)	2.52	(45,528)	2.19
Outstanding at end of year	<u>659,051</u>	<u>3.24</u>	<u>498,961</u>	<u>2.58</u>	<u>440,967</u>	<u>1.86</u>
Exercisable at end of year	<u>535,741</u>	<u>2.65</u>	<u>383,461</u>	<u>2.50</u>	<u>313,844</u>	<u>2.22</u>

A summary of information about the company's stock options outstanding at January 3, 2004 follows:

Range of exercise prices	Options Outstanding	Weighted average remaining contractual life	Weighted average exercise price	Options exercisable	Weighted Average remaining contractual Life	Weighted Average Exercise Price
\$0.50 - \$1.00	115,000	7.0	\$ 0.67	115,000	7.0	\$ 0.67
\$1.00 - \$2.00	175,341	5.7	1.53	175,341	5.7	1.53
\$2.00 - \$3.00	12,610	4.1	2.25	12,610	4.1	2.25
\$3.00 - \$4.00	211,100	8.2	3.89	187,110	8.1	3.89
\$4.00 - \$5.00	27,000	8.1	4.38	25,680	8.0	4.38
\$6.00 - \$7.00	98,000	10.0	6.24	0	10.0	6.24
\$10.00 - \$12.00	20,000	8.4	10.38	20,000	8.4	10.38
<u>\$0.50 - \$12.00</u>	<u>659,051</u>	<u>7.5</u>	<u>\$ 3.24</u>	<u>535,741</u>	<u>7.0</u>	<u>\$ 2.65</u>

In May 1995, the Board of Directors of the company and the shareholders authorized the adoption of an Employee Stock Purchase Plan ("ESPP") for the company's employees. An aggregate of 225,000 shares of common stock may be issued under the ESPP. Shares purchased under the ESPP shall be sold to participants at 85% of the reported price and the maximum number of shares that can be purchased by a participant is 1,000 shares per quarter. The ESPP shall continue in effect through May 31, 2005. During 2003, 2002 and 2001, 6,867, 6,558 and 17,776 shares were purchased, respectively, under the ESPP. As of January 3, 2004, a total of 120,770 shares have been purchased under the ESPP since its inception in May 1995.

NOTE 15- EARNINGS PER SHARE

A reconciliation of basic earnings per share to diluted earnings per share follows (in thousands, except per share data):

	2003			2002			2001		
	Income	Shares	Per-Share Amount	Income	Shares	Per-Share Amount	Income	Shares	Per-Share Amount
Basic EPS									
Income available to common stockholders	\$ 1,309	4,732	\$ 0.28	\$ 1,477	4,709	\$ 0.31	\$ 1,027	4,635	\$ 0.22
Effect of Dilutive Securities									
Convertible preferred stock		20			20			20	
Stock options		301			329			102	
Diluted EPS									
Income available to common stockholders plus assumed conversions	\$ 1,309	5,053	\$ 0.26	\$ 1,477	5,058	\$ 0.29	\$ 1,027	4,757	\$ 0.22

Options to purchase shares of the company's common stock in addition to the stock options reflected in the calculation above were outstanding during the years 2003, 2002 and 2001, but were not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares. The options were still outstanding as of January 3, 2004. Income available to common stockholders for each year presented above has not been affected by preferred dividends because the company has not declared any dividends on its preferred shares.

NOTE 16- COMMITMENTS AND CONTINGENCIES

Concentration of Risk. Financial instruments which could subject the company to concentration of credit risk are primarily cash and cash equivalents and receivables. The company places its cash and cash equivalents in insured depository institutions. At January 3, 2004, the company's uninsured cash balance totaled \$2,490,000. The company performs ongoing credit evaluations of its franchisees and when necessary maintains reserves for potential credit losses on receivables, which are not collateralized.

Litigation. The company is party to certain pending legal proceedings and claims in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the company is of the opinion that it is unlikely that these proceedings and claims will have a material effect on the results of operations or the financial condition of the company.

Report of Independent Auditors

To the Board of Directors and Stockholders of Back Yard Burgers, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Back Yard Burgers, Inc. and its subsidiaries at January 3, 2004, and December 28, 2002, and the results of their operations and their cash flows for each of the three years in the period ended January 3, 2004, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the consolidated Financial Statements, Back Yard Burgers adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, during 2002.



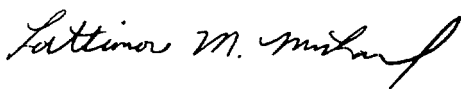
Memphis, Tennessee
March 11, 2004

Management's Statement of Responsibility for Financial Statements

The management of Back Yard Burgers, Inc. has the primary responsibility for the preparation and integrity of the consolidated financial statements and other financial information contained in the Annual Report. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles consistently applied in all material respects and reflect estimates and judgments by management where necessary. Financial information included throughout this annual report is consistent with the consolidated financial statements.

The company maintains a system of internal accounting control that is adequate to provide reasonable assurance that assets are safeguarded and transactions are executed and recorded in accordance with management's authorization. The adequacy of the company's internal accounting controls are under the general oversight of the audit committee of the board of directors, consisting of three outside directors. The committee reviews with the independent auditors the scope and results of the annual audit.

The 2003 consolidated financial statements have been audited by PricewaterhouseCoopers LLP, independent auditors, in accordance with generally accepted auditing standards. PricewaterhouseCoopers LLP was recommended by the audit committee of the board of directors, selected by the board of directors and ratified by the company's stockholders. The independent auditors develop and maintain an understanding of the company's systems and procedures and perform such tests and other procedures, including tests of the internal accounting controls, as they deem necessary to enable them to express an opinion on the fairness of the consolidated financial statements. Such opinion, based upon their audits of the consolidated financial statements, is contained in this Annual Report.



Lattimore M. Michael
Founder, Chairman and Chief Executive Officer



Michael G. Webb
Chief Financial Officer

Directors and Officers

Board of Directors

Lattimore M. Michael
Chairman and Chief Executive Officer

William N. Griffith
*Executive Vice President
And Secretary-Treasurer*

W. Kurt Henke
*Partner
Henke-Bufkin
(attorneys-at-law)*

Jim L. Peterson
*Chairman and Chief Executive Officer of
J. P. Family Restaurants Holding Company*

William B. Raiford, III
*Of Counsel
Merkel & Cocke
(attorneys-at-law)*

Joseph L. Weiss
*President, A. Weiss Company
(franchisee)*

Officers

Lattimore M. Michael
Chairman and Chief Executive Officer

Michael W. Myers
President and Chief Operating Officer

William N. Griffith
Executive Vice President and Secretary-Treasurer

Michael G. Webb
Chief Financial Officer

Corporate Information

Corporate Offices

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901-367-0888

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Registrar and Transfer Company
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800-368-5948

Independent Auditors

PricewaterhouseCoopers LLP
Memphis, Tennessee

General Counsel

Henke-Bufkin
Professional Corporation
Clarksdale, Mississippi

Securities Counsel

Kutak Rock, LLP
Little Rock, Arkansas

Annual Meeting of Stockholders

The company will hold its annual meeting of stockholders on May 20, 2004, at 10:00 a.m. local time, at The Ridgeway Inn, 5679 Poplar Avenue, in Memphis, Tennessee. Stockholders of record as of April 2, 2004, are invited to attend this meeting.

Annual Report on Form 10-K

A copy of the company's Annual Report on Form 10-K for the year ended January 3, 2004, as filed with the Securities and Exchange Commission, may be obtained by stockholders of record without charge upon request to the company.

Stockholder Account Assistance

For address changes, registration changes, lost stock certificates, or if you are receiving duplicate copies of the Annual Report, please contact Registrar and Transfer Company at the address or number listed above.

Stock Market Information

The company's common stock trades on the NASDAQ SmallCap Market tier of The NASDAQ Stock Market under the symbol BYBI. At March 16, 2004, the company had approximately 4,000 stockholders, including beneficial owners holding shares in nominee or "street" name.

Back Yard Burgers completed its initial public offering of common stock in June 1993 and began public trading on June 25, 1993. The table below sets forth the high and low closing bid prices for the two-year period ended January 3, 2004:

Quarter Ended:	High	Low
March 30, 2002	\$ 8.61	\$ 3.89
June 29, 2002	\$ 11.25	\$ 6.40
September 28, 2002	\$ 12.00	\$ 6.31
December 28, 2002	\$ 6.10	\$ 3.95
March 29, 2003	\$ 5.01	\$ 3.52
June 28, 2003	\$ 6.40	\$ 4.53
September 27, 2003	\$ 6.62	\$ 4.61
January 3, 2004	\$ 7.96	\$ 6.18

The company currently anticipates that it will retain all of its earnings to support its operations and the development of its business. Therefore, the company does not pay any cash dividends on its outstanding common stock. Future cash dividends, if any, will be at the discretion of the company's board of directors and will depend upon, among other things, future operations and earnings, capital requirements, general financial conditions, contractual restrictions, stock repurchases and other factors that the board may consider relevant.



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NASDAQ SYMBOL: BYBI